KPMG

TaxNewsFlash

United States

No. 2019-599
December 17, 2019

KPMG report: Proposed regulations under section 162(m) to address tax law changes (initial impressions)

The U.S. Treasury Department and IRS yesterday afternoon (December 16, 2019) released for publication in the Federal Register proposed regulations (REG-122180-18) that reflect changes made to section 162(m) from the 2017 tax law (Pub. L. No. 115-97, the law that is often referred to as the "Tax Cuts and Jobs Act" (TCJA)).

Section 162(m) generally disallows a deduction for compensation paid in any tax year to a covered employee of a publicly held corporation that exceeds $1 million.

The proposed regulations confirm the interpretations from Notice 2018-68 and update the definitions of covered employee, publicly held corporation, and applicable employee compensation as well as provide a significant number of useful examples applying the guidance. Read the **proposed regulations** [PDF 434 KB] (36 pages as published in the Federal Register)

The following report provides initial impressions about these proposed regulations.

Definition of "publicly held corporation"

- The proposed regulations define a "publicly held corporation" as any corporation that issues securities required to be registered under section 12 of the Securities Exchange Act of 1934 ("Exchange Act") or that is required to file reports under section 15(d) of the Exchange Act.

- The proposed regulations refer to the last day of the corporation's tax year to determine whether it is publicly traded.

- A "foreign private issuer" (FPI) is a publicly held corporation if it is required either to register its securities under section 12 of the Exchange Act or to file reports under section 15(d) of the Exchange Act. The proposed regulations did not adopt the recommendation to exclude FPIs from section 162(m). However, the IRS requests comments on whether a safe harbor for the determination of the three highest paid individuals is appropriate for FPIs that are not required to disclose compensation of their officers on an individual basis in their home countries.

Covered employee

- The proposed regulations adopt the positions in Notice 2018-68. The three highest paid executive officers for the tax year are determined regardless of whether an executive officer is serving at the end of the tax year. The definition of "covered employee" is proposed to apply to tax years ending on or after September 10, 2018 (the publication date of Notice 2018-68).

- When the tax year and fiscal year do not end on the same date, the proposed regulations provide that the amount of compensation used to identify the three most highly compensated executive officers is determined with the SEC rules, but using the tax year end. The same analysis applies for short tax years.

  Example: Public company uses a calendar year for fiscal year SEC reporting, but uses a tax year of July 1, 2019, through June 30, 2020. The three highest compensated executive officers are determined under the SEC rules as if the fiscal year ran from July 1, 2019, through June 30, 2020.

- The proposed regulations provide that for a corporation having fiscal and tax years that do not end on the same date, the rule requiring the determination of the three most highly compensated executive officers to be made pursuant to SEC rules applies to tax years beginning on or after December 20, 2019 (date of publication in Federal Register).

Predecessor corporation

- The proposed regulations describe predecessor corporations in the context of four categories: (1) corporate reorganizations, (2) corporate divisions, (3) stock acquisitions, and (4) assets acquisitions; and include multiple examples of the application of the predecessor rules.

- The proposed regulations provide that a predecessor of a publicly held corporation includes a publicly held corporation that becomes privately held and then becomes publicly held again within 36 months of the due date of the return last filed as publicly held.

- The proposed regulations on defining predecessor corporation are proposed to apply to corporate transactions for which all events necessary for the transaction occur on or after December 20, 2019.

- The definition of the term predecessor corporation of a publicly held corporation applies to a privately held corporation that again becomes a publicly held corporation on or after December 20, 2019.

- Until the regulations are finalized, taxpayers can use the definition of predecessor in the proposed regulations or a reasonable good faith interpretation of the term. However, excluding a target corporation in the following situations would not be a reasonable good faith interpretation: (1) a publicly held target corporation the stock or assets of which are acquired by another publicly held corporation in a transaction to which section 381(a) applies; and (2) a publicly held target corporation at least 80% of the total voting power, and at least 80% of the total value of the stock of which is acquired by a publicly held acquiring corporation.

Applicable employee remuneration

- **Compensation for services in capacity other than executive officer:** A covered employee remains a covered employee after separation from service. If the covered employee returns to provide services to the publicly held corporation in any capacity—employee, director, or independent contractor—any deduction for compensation is subject to section 162(m). The proposed regulations did not adopt commentators' suggestions to limit applicable compensation to services provided as an executive officer.

- **Compensation paid by a partnership to a covered employee:** If a publicly held corporate partner is allocated a distributive share of the partnership's deduction for compensation paid by the partnership, the allocated distributive share is subject to section 162(m) even though the corporation did not pay the compensation to the covered employee. This position is contrary to four private letter rulings issued between 2006 and 2008 that allowed reasonable compensation to be paid from a lower-tiered partnership to partnership employees without affecting the section 162(m) deduction limitation.

  In acknowledging that taxpayers have taken positions contrary to this new definition of compensation, the proposed regulations provide transition relief. This partnership provision is proposed to apply to any deduction for compensation that is otherwise allowable for a tax year ending on or after December 20, 2019. The definition of compensation does not apply to compensation paid pursuant to a written binding contract in effect on December 20, 2019, that is not materially modified after that date.

Privately held corporations that become publicly held

- The final regulations under Reg. section 1.162-27 provided an initial public offering (IPO) exception allowing a transition period under section 162(m) for company that becomes publicly traded. The proposed regulations do not provide a similar IPO exception.

- The proposed regulations provide that section 162(m) applies to the deduction for any compensation otherwise deductible for the tax year ending on or after the date the corporation becomes publicly traded. A corporation is considered to become publicly held on the date that its registration statement becomes effective under either the Securities Act of 1933 or the Securities Exchange Act of 1934.

- The proposed rules on privately held corporations that become publicly held are proposed to apply to a corporation that becomes publicly held after December 20, 2019. A corporation that was not publicly held and then becomes publicly held on or before December 20, 2019, may rely on the transition relief as provided in Reg section 1.162-27(f)(1) until the earlier of the events provided in Reg. section 1.162-27(f)(2).

Grandfathering rules

- **Grandfathering:** The proposed regulations adopt the rules provided in Notice 2018-68, and grandfathering is allowed only to the extent that the corporation is obligated to pay under applicable law. Amounts paid that exceed the amount the corporation is obligated to pay under the written binding contract in effect on November 2, 2017, are subject to the expanded section 162(m) rules. The definition of written binding contract is proposed to apply to tax years ending on or after September 10, 2018.

- **No safe harbor:** The proposed regulations do not adopt a safe harbor for grandfathering. Despite requests of a safe harbor based on amounts accrued under GAAP, the proposed regulations do not adopt such safe harbor.

- **Discretion:** The proposed regulations acknowledge that compensation arrangements may provide a corporation with a greater negative discretion than applicable law permits. Negative discretion is only taken into account to the extent the corporation may exercise the negative discretion under applicable law. A corporation is not treated as having discretion because it has discretion to recover an amount if a condition occurs after the vesting and payment of the compensation and the occurrence are outside the corporation's control.

  Example: A corporation permitted recovery of part of a bonus if the employee is convicted of a felony within three years. If the employee is not convicted, the amounts remains grandfathered. If the employee is convicted, the portion subject to recovery is not grandfathered.

- **Nonaccount balance plans:** The amount grandfathered is the amount the corporation is obligated to pay under applicable law on November 2, 2017.

- **Earnings:** The proposed regulations provide that earnings credited after November 2, 2017, on grandfathered amounts are grandfathered only if the corporation is obligated to pay the earnings under applicable law pursuant to a written binding contract in effect on November 2, 2017.

- **Severance agreements:** Severance payments can be grandfathered only if the amount of severance is based on compensation elements the employer is obligated to pay under the contract in effect on November 2, 2017. Each compensation element is analyzed separately. Further, if an employee remains employed as of November 2, 2017, only the amount the corporation would have been required to pay if the employee had been terminated as of November 2, 2017, is grandfathered.

- **Material modifications:** The proposed regulations generally adopt the definition of material modification used in Notice 2018-68. However, if amounts are paid to an employee under multiple contracts, the material modification of one contract does not automatically result in the material modification of the other contracts unless the modification affects the amounts payable under those other contracts. In addition, the proposed regulations provide that the modification of an equity award (restricted property, stock option, or stock appreciation right) or other compensation arrangement to accelerate vesting is not a material modification. The definition of material modification is proposed to apply to tax years ending on or after September 10, 2018.

- **Section 409A:** The rules under section 409A are to be modified to provide that a service recipient may delay the schedule payment of grandfathered amounts without delaying the payment of non-grandfathered amounts, and the delay of the grandfathered amounts is not treated as a subsequent deferral. Further, if a nonqualified deferred compensation arrangement is amended to remove the provision requiring the corporation to delay a payment if the corporation reasonable anticipates that the deduction would not be permitted under section 162(m), the amendment does not result in an impermissible acceleration and is not considered a material modification. The plan amendment must be made by December 31, 2020.

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